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Discussant's Response to A Look at the Record on Auditor Detection of Management Fraud

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I am pleased to review Donald Ziegler's paper on "A Look at the Record on Auditor Detection of Management Fraud." As chairman of The Standing Subcommittee on Methods of Perpetration and Detection of Fraud, Ziegler speaks from a position of considerable knowledge, and his paper reflects the significant work of that subcommittee. Because I challenge only a point or two in the paper, I have chosen to emphasize and expand several of the points raised. Hence, I would like my remarks to be viewed as complementary to those of Mr. Ziegler.

The matters I have selected for emphasis are the following:

1. My understanding of the meaning of "management fraud."
2. The materiality threshold for fraud.
3. The relationship of internal control to management fraud.
4. Ziegler's four-point program for fraud detection.
5. Management fraud and implications for research.

The Meaning of Management Fraud

Because "management fraud" contains the adjective "management," the term is meant to be distinguished from fraud in general. While all fraud involves deceit, trickery, or cheating, management fraud connotes special characteristics. In my judgment, management fraud contains three special characteristics as follows:

1. The fraud is perpetrated at levels of management above those to which internal control systems generally relate.
2. The fraud frequently involves using the financial statements to create an illusion that an entity is more healthy and prosperous than it actually is.
3. If the fraud involves the misappropriation of assets, it frequently is shrouded in a maze of complex transactions often involving related third parties.

ASB (Auditing Standards Board), in its discussion of limitations on the effectiveness of internal control, makes the point that controls can be overridden by certain levels of management. In SAS Section 320.34, ASB states as follows: "... procedures designed to assure the execution and recording of transactions may be ineffective against either errors or irregularities perpetrated by management with respect to transactions or to the estimates and judgments required in the preparation of financial statements." ASB reaffirms the point in SAS Section 327.09 in

which it states: “. . . management can perpetrate irregularities by overriding controls that would prevent similar irregularities by other employees.” The implications for auditing appear clear. Whenever the auditor sets about to test for management fraud, little, if any, reliance can be placed on internal control.

When financial statements are used to create an illusion, the input data usually is manipulated to include false or questionable transactions or to include false or questionable judgments with respect to expense allocations or revenue recognition. The incentive for such deceit may be (1) to stave off creditors, (2) to raise investment capital at a cheaper cost than justified, or (3) to provide for subtle misappropriation of assets. With respect to the latter point, the financial statements may be manipulated to increase EPS for the purpose of enhancing the value of share options or management bonuses.

If management fraud involves the misappropriation of assets, it frequently is the case that the fraud is covered by overstated assets just like McKesson-Robbins and its fictitious receivables and inventory. Almost, but not quite. Today the McKesson-Robbins type coverup would be caught by the auditor through accounts receivable confirmation or inventory observation. Hence, the coverup frequently involves complex transactions often involving related third parties. This has made it possible either to confound the auditor or to provide some evidence of *bona fides*.

Hopefully, consideration of the characteristics of management fraud will help place in perspective the audit risks involved.

Materiality Threshold for Fraud

Ziegler's point is well taken with respect to differing perceptions of the auditor's responsibility for fraud detection. Although the SEC may not believe that the auditor should be held responsible for ALL management fraud, it certainly appears that the materiality threshold is lower than for other types of errors. For example, the Commission's final rules on application of the Foreign Corrupt Practices Act have been criticized for omitting materiality standards. Perhaps some small comfort can be taken from the following quote in the release (Section 34-15570—February, 1979):

The SEC believes that the concern expressed with respect to inadvertent and inconsequential errors is unwarranted. The statute does not require perfection, but only that the books, records, and accounts “*in reasonable detail*, accurately and fairly reflect transactions and dispositions of the assets of the issuer.”

I say *small* comfort when I read Commissioner John Evans' response to criticism for omission of the materiality standard (*The Week in Review*, Delotte Haskins & Sells, November 30, 1979):

I do *not* expect to see a positive response in any Commission action at this time. Congress determined not to include the materiality concept in the Foreign Corrupt Practices Act, and for the Commission to engraft it now through a management report requirement could obfuscate that point. Moreover, it might lessen the sensitivity of all of us to what the Act requires.

Although I completely agree with Ziegler that the appropriate degree of audit

responsibility for fraud detection should be limited to those frauds having a material impact on financial statements, and although ASB (SAS Section 327.05), clearly makes this point (clarifying ambiguities contained in SAS #1 Section 110.05 08), it now appears that public expectations may have overridden the profession's attempt to establish clear and reasonable limits of responsibility. Hence, I am considerably less optimistic than is Mr. Ziegler that a GAAS audit will be sufficient defense with respect to undetected management fraud. In fact, I believe the profession must face the necessity (1) of distinguishing between financial statement errors involving *bona fides* of transactions or account balances and (2) those involving unintentional mistakes or poor judgment and for developing auditing standards applicable to each type of error. Perhaps reasonable standards would call for auditing in a fraud mode¹ only if indicated by appropriate warning signals. Several lists of such signals exist, but I would commend the listing prepared by the Ziegler subcommittee and published in *The CPA Letter* (AICPA, March 12, 1974, P 4).

The Relationship of Internal Control to Management Fraud

For purposes of discussion, I have assumed that management frauds are perpetrated at levels of management above those for which internal controls systems generally are designed to be effective. Thus, if as a consequence of warning flags, the auditor chooses to test for management fraud, all tests must be substantive and no reliance can be placed on the system of internal control.

In preparing my remarks, I reviewed a number of the SEC's Accounting Series Releases (ASR's) in which the Commission has chosen to spell out the details of cases purported to involve auditing deficiencies.² A number of these cases indicated that the auditor placed inappropriate reliance on the client's internal controls. However, inappropriateness was often related to weak controls. This criticism is unfortunate. It misses the point that, with respect to management fraud, control systems are irrelevant. In my judgment, the criticisms should have taken the form that the circumstances called for auditing in the fraud mode and, hence, no reliance should have been placed on the control system. The point is illustrated by ASR #209, in which the Commission states in its conclusion the following:

When confronted with evidence that an audit client's internal accounting controls are unreliable, independent auditors should employ detailed expanded procedures and insist upon obtaining evidential matter from external sources. In this instance, (the auditor) . . . improperly relied upon the accounting data developed by Tidal. . . .

In my judgment, the conclusion may lead to the unwarranted implication that, had the controls been strong, the auditor could more properly have relied on the accounting data developed by management. The fact is that the frauds were perpetrated by levels of management high enough to override even a strong control system.

Nevertheless, while it currently is inappropriate to rely on internal control when auditing in a fraud mode, because of severe responsibilities imposed on auditors for the detection of management fraud, consideration should be given to whether control standards can effectively be imposed on higher levels of manage-

ment than are currently contemplated. It may be feasible, for example, to carry the concept of "separation of duties" to higher levels. Thus, the generally recognized functions of general auditor, operations, treasurer, and controller might remain separated and independent to a level even as high as the board of directors.

The feasibility of the foregoing suggestion is at least indicated by data gathered for as yet unpublished research. Among a sample of the companies in the Fortune 500, 17% of the general auditors reported to a member of the board of directors in 1980 as compared to 9% in 1976. Whether raising reporting levels would be effective in deterring management fraud is a question best left to either experience or research. In any event, in my judgment, the matter deserves serious consideration.

Ziegler's Four-Point Program For Fraud Detection

In this section, I am going to challenge another of Mr. Ziegler's conclusions. He lists a four-point program for which he sort of apologizes for whether it is too simple and not sufficiently enlightening. In my judgment, that program is quite enlightening and is made elegant by its simplicity. In order to add emphasis to the points made, I have taken the liberty of repeating the list:

1. Watch out for overstated assets and understated liabilities.
2. Be wary of related party transactions.
3. Pay particular attention to large complex transactions.
4. Get to know your client, his business and his industry before you report on his financial statements.

I would like to address these items in more detail and I will begin with the last one.

Every treatise on epistemology contains the admonition that the conduct of inquiry requires thorough knowledge by the investigator of the matter under investigation. Kerlinger states as follows:

If one wants to solve a problem one must generally know what the problem is. It can be said that a large part of the solution lies in knowing what it is one is trying to do.³

Cohen and Nagel make the point when they discuss the relevance of hypotheses:

In the absence of knowledge concerning a subject matter, we can make no well-founded judgment of relevance. It follows that valuable suggestions for solving a problem can be made only by those who are familiar with the kinds of connections which the subject matter under investigation is capable of exhibiting.⁴

I assert that the prior knowledge required of the auditor is, at the absolute minimum, a thorough knowledge of the client's business and the client's industry. For example, the question of inventory obsolescence and how to test for it would be very different for a retailer as compared to an airplane manufacturer. My ability to design (and, yes, to carry out) the appropriate test would depend on my knowledge of each client and each industry.

Why am I belaboring such an obvious point? In the ASR's I selected for review, over and over again, the point is made by the Commission that the auditor

simply did not understand the client's business. Examples are contained in the following quotes:

ASR #173: . . . the auditors accepted assertions by management concerning the special circumstances of the business involved although presentation of the supposed results presented unusual accounting and auditing problems. In considerable measure this occurred because the auditors were not sufficiently familiar with the business context to assess the representations of management.

ASR #227: The Commission has previously addressed the audit considerations inherent in having a thorough familiarity with the transactions being audited.

ASR #241: The senior accountant assigned to the engagement has no prior experience in auditing broker-dealers and was not provided with an audit program containing specific procedures designed for broker-dealers.

In my judgment, prerequisite knowledge of the client's business is so fundamental to audit inquiry that steps should be taken to assure that such knowledge pervades the entire audit team. I wonder how many staff training programs are directed to specific industries and specific clients. I assert that inclusion of such programs in the training budgets of accounting firms would be cost-beneficial.

Consider now the question of related party transactions. These are specifically covered by ASB in SAS #6 issued in July 1975. A number of the audit failures in the SEC-described cases were attributable, at least in part, to insufficient attention given to the propriety of such transactions. I counted six references to related party transaction with the following quote being typical:

ASR #227: When one party to a transaction is able to influence the operating policies of another party, the risk of the transaction lacking a legitimate business purpose rises substantially. In this regard, the auditors should have intimate familiarity with the business of the client in order to understand the opportunities which may exist for such transactions.

Careful application of SAS #6 should materially reduce the likelihood that those frauds involving related party transactions would go undetected.

Many of the SEC described cases involved large complex transactions. These transactions appear to have been conceived either to have created the illusion of legitimacy or simply to confound the auditor. The essence of the SEC criticism in these cases is that the auditor simply accepted management's representations regarding the underlying events rather than to dig down and obtain the necessary confirming evidence. Frankly, I am somewhat sympathetic with the poor auditors on these engagements. For example, Penn Central (ASR #173) involved almost at the same time not one but eight transactions each of which seemed to me to be truly mind-boggling. In one year, Tidal Marine International (ASR 209) involved five equally mind-boggling transactions.

In one of the Tidal Marine transactions, the auditor was attempting to test the collectability of a receivable from a company named Transoceanic for \$1,082,058. In order to satisfy the auditor concerning the collectability of this receivable which had been created from a fictitious revenue transaction, Tidal's management furnished to the auditor an agreement and release involving four affiliated companies. The agreement recited that Tidal owed Barclay at least

\$1,082,058, that Barclay owed Panocean \$1,094,472, that Panocean owed Transoceanic \$1,252,058, and Transoceanic owed Tidal \$1,082,058. With certain adjusting payments all of the indebtedness was extinguished and the auditor now had evidence of a collectible receivable.

Transactions of comparable complexity were found in five other cases. It also is interesting to note that many of the highly complex transactions used to deceive the auditor also involved related parties. Thus, the combination appears to be quite devastating with respect to the audit risk of undetected management fraud.

It also is interesting to note that virtually every case detailed by the SEC involved financial statements with either overstated assets or understated liabilities.⁹ Overstated assets were either fictitious or overvalued. In many cases, the misstatements either were created or shrouded over by complex related-party transactions. Most of the other cases seemed to involve front-ended revenues, capitalized expenses, and unrecognized liabilities. I hope all of this indicates a continuing role for the balance-sheet audit, which I am sometimes led to believe is on the endangered species list. I hope not. Because, given the fact that management fraud is beyond the scope of internal controls as currently conceived, the balance sheet audit should continue to have a significant role in the audit process.

Management Fraud and Implications For Research

I share Don Ziegler's disappointment with the difficulty of obtaining indepth analyses of fraud cases and auditing procedures which have proven effective in either revealing or thwarting fraud. I would guess that the difficulty stems, not only from the concern for the legal implications, but also the reluctance of people to put in the many hours of work required. Any academic in the room can attest to the meticulous planning and arranging that must be made to get adequate responses to a questionnaire of even modest length or to get persons to serve as experimental subjects. In my judgment, the information being sought by the Ziegler subcommittee would have to be packaged up and be presented to and be "blessed" by the executive committee of every participating accounting firm.

Management fraud also should be a fruitful field for academic research. The work of Albrecht and Romney (including their paper to be discussed in the next session) is particularly encouraging in this respect.

I will be so presumptuous as to list two or three other possibilities:

1. Design and test the effectiveness of internal controls directed to top management.
2. Design simulated frauds to test the effectiveness of alternative auditing procedures.
3. Design and conduct staff training programs directed to understanding the business of specific industries and specific companies. The research might include follow-up tests of the effectiveness of such training.

Summary and Conclusions

1. Management fraud suggests three special characteristics—

- (1) The fraud is perpetrated at levels of management above those for which internal controls generally are designed.
- (2) It frequently involves using the financial statements to create an

illusion that an entity is more healthy and prosperous than it actually is.

- (3) If misappropriation of assets is involved, it frequently is shrouded in a maze of complex transactions often involving related third parties.
2. I am less optimistic than is Mr. Ziegler that a GAAS audit will be sufficient defense with respect to undetected management fraud. I fear that public expectations already have overridden the profession's attempt to establish reasonable limits of responsibility.
3. Internal controls generally are not designed to control higher levels of management. Consideration should be given to whether controls can be redesigned to be more effectively imposed on higher levels of management.
4. The four points in Mr. Ziegler's program comprise significant audit standards directed to management fraud. They surely contain the essence of the issues contained in the cases found on the public record.
5. Because undetected management fraud impacts so severely on auditors, aspects of management fraud should be fruitful areas of research both for professional accountants and academics.

Footnotes

1. See W. Donald Georgen, "Management Behavior—an Auditing Horizon," *Auditing Symposium III*, University of Kansas School of Business, 1976. Mr. Georgen suggests the term "fraud mode" and the circumstances for auditing in such a mode.

2. Accounting Series Releases issued by the SEC reviewed for this paper are the following:

ASR #173 issued July 2, 1975.

ASR #196 issued September 1, 1976.

ASR #209 issued February 16, 1977.

ASR #210 issued February 25, 1977.

ASR #227 issued September 21, 1977.

ASR #238 issued January 16, 1977.

ASR #241 issued February 10, 1978.

3. Fred N. Kerlinger, *Foundations of Behavioral Research*, Second Edition, Holt, Rinehart and Winston, Inc., 1973, p 17.

4. Morris R. Cohen and Ernest Nagel, "The Occasion and the Function of Inquiry," *Knowledge and Value*, Second Edition, Edited by Elmer Sprague and Paul W. Taylor, Harcourt, Brace & World, Inc., 1967, p 223.

5. This is not meant to ignore the fact that management may be motivated toward the "flip side," i.e., understated assets or overstated liabilities. For example, smaller companies may wish to "save" taxes; energy-related companies may wish to reduce reported profits below the "obscene" level.